

STAFF PAPER

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Project	Lack of Exchangeability (IAS 21)		
Paper topic	Possible narrow-scope standard-setting		
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Introduction and purpose

1. As explained in Agenda Paper 12A, the IFRS Interpretations Committee (Committee) decided to recommend that the International Accounting Standards Board (Board) undertake standard-setting to address the exchange rate an entity uses when exchangeability between two currencies is lacking.
2. The purpose of this paper is to
 - (a) present background information;
 - (b) present the Committee's recommended approach to standard-setting; and
 - (c) ask the Board whether it agrees with the Committee's recommendation to undertake a narrow-scope standard-setting project.

Structure of the paper

3. This paper includes:
 - (a) background information (paragraphs 5–18); and
 - (b) an assessment of the standard-setting criteria in 5.16–5.21 of the *Due Process Handbook* (paragraphs 19–36).
4. The paper has three appendices:
 - (a) Appendix A—Agenda decision published in November 2014;

- (b) Appendix B—Agenda decision published in September 2018; and
- (c) Appendix C—Stakeholder comments on Committee’s decision to research possible narrow-scope standard-setting.

Background information

The requirements in IAS 21

5. Paragraph 8 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* includes the following definitions:
 - ...Closing rate is the spot exchange rate at the end of the reporting period...
 - ...Exchange rate is the ratio of exchange for two currencies...
 - ...Spot exchange rate is the exchange rate for immediate delivery.
6. When an entity reports foreign currency transactions in the functional currency, IAS 21 requires the entity to use:
 - (a) the spot exchange rate (as defined in paragraph 8) at the date of the transaction on initial recognition of the transaction; and
 - (b) the closing rate (as defined in paragraph 8) when translating foreign currency monetary items at the end of each reporting period.
7. When an entity uses a presentation currency other than the functional currency, IAS 21 requires the entity to translate:
 - (a) assets and liabilities at the closing rate, and income and expenses at exchange rates at the dates of the transactions (if the functional currency is not the currency of a hyperinflationary economy). In our view, the exchange rate at the date of the transaction is the spot exchange rate (spot rate) on that date—this is because it is only the spot rate that would reflect the exchange rate at that date; and

- (b) all items (ie assets, liabilities, equity items, income and expenses) at the closing rate if the functional currency is that of a hyperinflationary economy.
8. When a currency is subject to a lack of exchangeability¹, an entity is unable to exchange that currency for another currency. The absence of an exchange transaction means that an entity cannot observe a spot rate. Accordingly, whenever a currency is not exchangeable, there is no observable spot rate for the currency.
9. Paragraph 26 of IAS 21 includes requirements in relation to a lack of exchangeability but only for foreign currency transactions reported in the functional currency. It states:
- ...If exchangeability between two currencies is temporarily lacking, the rate used is the first subsequent rate at which exchanges could be made.
10. IAS 21 does not say anything further about exchangeability. It does not specify the circumstances in which exchangeability is temporarily lacking, nor does it provide requirements for a lack of exchangeability that is other than temporary.

The Committee’s agenda decision published in November 2014

11. In 2014, the Committee considered the exchange rate an entity uses to translate the results and financial position of a foreign operation into its presentation currency when the foreign operation’s functional currency is subject to a lack of exchangeability that is other than temporary—ie a long-term lack of exchangeability.
12. The Committee published an agenda decision in November 2014 (the 2014 agenda decision) stating:
- ...The [...] Committee observed that a [long]-term lack of exchangeability is not addressed by the guidance in IAS 21, and so it is not entirely clear how IAS 21 applies in such situations. However, the [...] Committee thought that addressing this issue is a broader-scope project than it could address. Accordingly,

¹ Throughout this paper, for ease of reference, we refer to ‘a currency’s exchangeability’ or ‘lack of exchangeability’. IAS 21 refers to the exchangeability between two currencies.

the [...] Committee decided not to take this issue onto its agenda...

13. Appendix A to this paper reproduces the 2014 agenda decision.

The Committee’s agenda decision published in September 2018

14. In 2018, the Committee considered the determination of the exchange rate an entity uses to translate the results and financial position of a foreign operation into its presentation currency applying IAS 21. The Committee considered this matter in the following circumstances:

- (a) the exchangeability of the foreign operation’s functional currency with other currencies is administered by jurisdictional authorities. This exchange mechanism incorporates the use of an exchange rate set by the authorities (official exchange rate).
- (b) the foreign operation’s functional currency is subject to a long-term lack of exchangeability with other currencies—ie the exchangeability is not temporarily lacking as described in paragraph 26 of IAS 21; it has not been restored after the end of the reporting period.
- (c) the lack of exchangeability with other currencies has resulted in the foreign operation being unable to access foreign currency using the exchange mechanism described in paragraph 14(a) above.

15. The Committee observed that those circumstances exist in Venezuela. The Committee discussed whether, in those circumstances, an entity is required to use an official exchange rate in applying IAS 21. The Committee published an agenda decision in September 2018 (the 2018 agenda decision) explaining how an entity applies IAS 21 in assessing whether it uses the official exchange rate to translate into its presentation currency the results and financial position of a foreign operation.

16. Appendix B to this paper reproduces the 2018 agenda decision.

17. That agenda decision does not discuss the exchange rate an entity uses if the official exchange rate, as well as any other observable exchange rate, do not meet the definition of a spot rate. This is because IAS 21 has no requirements in this respect. IAS 21 requires an entity to use the closing rate (or exchange rates at the dates of

transactions) when translating the results and financial position of a foreign operation, and thus IAS 21 requires the use of the spot rate. IAS 21 does not contemplate a situation in which the spot rate is not observable.

The matter being addressed in the Committee’s research

18. When discussing this topic in 2014 and 2018, the Committee observed that IAS 21 does not specify how an entity would determine the spot rate when it is not observable, which arises when a currency’s exchangeability is subject to a long-term lack of exchangeability. Consequently, in 2018 the Committee decided to research possible narrow-scope standard setting to address situations in which an entity might conclude that the spot rate is not observable.

Assessment of whether the matter meets the criteria for narrow-scope standard-setting

19. The Committee recommends that the Board add a project to its workplan to address the exchange rate an entity uses when exchangeability between two currencies is lacking.
20. We have analysed below whether such a project would meet the criteria for narrow-scope standard-setting as specified in paragraphs 5.16–5.17 and 5.21 of the IFRS Foundation’s [*Due Process Handbook*](#).

***Is the matter widespread and expected to have a material effect on those affected?*²**

21. In analysing the matter for the Committee’s discussion, we reviewed IFRS financial statements of twenty entities that describe the accounting for their Venezuelan foreign operations. We also surveyed a sample of entities with Venezuelan foreign operations using a questionnaire to gain an in-depth understanding of their reporting practices. Our research focused on Venezuelan foreign operations—this is because Venezuela was, at that time (to the best of our knowledge), the only jurisdiction for which the

² Paragraph 5.16(a) of the *Due Process Handbook*.

matter discussed in this paper arose³. Paragraphs 17–20 of [Agenda Paper 3](#) for the May 2018 Committee meeting provide further details on our research and findings.

22. Our research identified that:
 - (a) the matter had a material effect for some entities and may result in a material effect for others in the near term; and
 - (b) there was diversity in reporting practices. We identified three main reporting practices:
 - (i) the use of one of the official exchange rates⁴;
 - (ii) the use of an estimated exchange rate, adjusted to reflect inflation in Venezuela; and
 - (iii) the deconsolidation of Venezuelan foreign operations.
23. Since May 2018, we have been made aware that developments in some other jurisdictions could lead to other currencies being subject to a lack of exchangeability. We note that a currency’s lack of exchangeability often arises when the economy of that currency is hyperinflationary.
24. Some Committee members acknowledged that circumstances in which exchangeability is lacking might arise infrequently because it affects relatively few jurisdictions. However, they said, when those circumstances arise, the situation can deteriorate rapidly and can have a material effect on the financial statements of entities affected by the lack of exchangeability.
25. Accordingly, we conclude that this matter is widespread and could have a material effect on those affected.

³ The restrictions on the exchangeability of the Venezuelan Bolivar were so severe that many entities were unable to access foreign currencies and, thus, were unable to observe any spot rate.

⁴ At the date of our research, there were two official exchange rate mechanisms in Venezuela for buying or selling Venezuelan Bolivar against foreign currencies (‘DIPRO’ and ‘DICOM’).

***Is it necessary to add to or change IFRS Standards to improve financial reporting?*⁵**

26. As explained in paragraphs 6–11 of this paper, IAS 21 includes requirements in relation to exchangeability that is temporarily lacking but only for foreign currency transactions reported in the functional currency. IAS 21 does not specify the circumstances in which exchangeability is temporarily lacking, nor does it provide requirements for a lack of exchangeability that is other than temporary.
27. Accordingly, the principles and requirements in IAS 21 do not provide an adequate basis for an entity to determine the exchange rate to use when exchangeability is lacking. As explained in paragraph 23(b) of this paper, entities apply diverse reporting methods (including using estimated exchange rates), which could hinder comparability and reduce the usefulness of information for users of financial statements. In the absence of requirements in this area, there is also a risk that entities might inappropriately estimate exchange rates in other situations by analogy.
28. Accordingly, we conclude that it is necessary to amend IAS 21 to address the matter, thereby improving financial reporting.

***Can the matter be resolved efficiently (is it sufficiently narrow in scope)?*⁶**

29. In developing its recommendations, the Committee focussed on identifying an approach that would avoid both reconsidering any fundamental principles and requirements in IAS 21 and addressing other aspects of IAS 21 or other Standards. The Committee therefore rejected any approach that would require an amendment to other IFRS Standards (such as creating an exception to the consolidation requirements in IFRS 10 *Consolidated Financial Statements*).
30. The Committee considered the following two approaches:
- (a) develop requirements on the exchange rate an entity uses in the limited circumstances described in the 2018 agenda decision (ie the circumstances listed in paragraph 14 of this paper) [Approach A]; or

⁵ Paragraph 5.16(b) of the *Due Process Handbook*.

⁶ Paragraphs 5.16(c) and 5.17 of the *Due Process Handbook*.

- (b) address more broadly:
 - (i) what constitutes a currency’s exchangeability and, thus, a lack of exchangeability; and
 - (ii) develop requirements that would apply in those circumstances [Approach B].
31. The Committee observed that Approach A would (a) result in a targeted narrow-scope amendment to IAS 21 that would resolve a known problem in practice, and (b) be relatively simple to develop. Nonetheless, the Committee decided to recommend Approach B. This is because:
- (a) the benefits of Approach B would be greater than those derived from Approach A. Approach A would address only extreme situations which do not occur frequently (even though they currently exist in Venezuela). The Committee has been informed that the absence of requirements in IAS 21 on this matter can create problems in jurisdictions in which entities have no (or restricted) access to foreign currency but the situation is not as extreme as that in Venezuela. Several respondents to the 2018 tentative agenda decision supported undertaking standard-setting along the lines of Approach B—Appendix C to this paper summarises those comments.
 - (b) Approach B would provide greater clarity on when a currency’s exchangeability is lacking and, by doing so, would specify the circumstances in which an entity uses a spot rate that is not observable.
32. The Committee’s recommendations in Agenda Papers 12C and 12D on this matter (developed applying Approach B) would not lead to fundamental changes to the requirements in IAS 21, but instead add requirements relating to a lack of exchangeability. The recommendations are narrow in scope and consistent with the existing principles and requirements in IAS 21.
33. Accordingly, we conclude that the Committee’s recommended approach to address this matter [ie Approach B] would result in addressing the matter efficiently within the confines of existing IFRS Standards.

***Would any solution developed be effective for a reasonable period of time?*⁷**

34. As part of its *2015 Agenda Consultation*, the Board decided not to add to its work plan a project on foreign currency translation. The Board currently has no project that would address the matter.
35. Accordingly, any solution developed by the Committee and Board would be effective for a reasonable period of time.

Staff conclusion

36. Having considered the criteria in the *Due Process Handbook* (discussed above in paragraphs 26–35), we conclude that the matter meets the criteria for narrow-scope standard-setting.

Question for the Board

Does the Board agree with the Committee's recommendation to undertake a narrow-scope standard-setting project to address the exchange rate an entity uses when exchangeability between two currencies is lacking?

⁷ Paragraph 5.21 of the *Due Process Handbook*.

Appendix A—Agenda decision published in November 2014⁸

IAS 21 The Effects of Changes in Foreign Exchange Rates—Foreign exchange restrictions and hyperinflation

The Interpretations Committee received a request for guidance on the translation and consolidation of the results and financial position of foreign operations in Venezuela. The issue arises because of strict foreign exchange controls in Venezuela. This includes the existence of several official exchange rates that may not fully reflect the local rate of hyperinflation and of restrictions over the amount of local currency that can be exchanged.

Concerns were raised that using an official exchange rate to translate an entity's net investment in a foreign operation in Venezuela appeared not to appropriately reflect the financial performance and position of the foreign operation in the group's consolidated financial statements.

The Interpretations Committee identified two primary accounting issues:

- (a) which rate should be used to translate the entity's net investment in the foreign operation when there are multiple exchange rates?
- (b) which rate should be used when there is a longer-term lack of exchangeability?

With respect to the first issue, the Interpretations Committee observed very little diversity in the application of IAS 21 regarding the principle to use when determining which rate, out of multiple rates, to use to translate an entity's net investment in a foreign operation. The Interpretations Committee noted that predominant practice is to apply the principle in paragraph 26 of IAS 21, which gives guidance on which exchange rate to use when reporting foreign currency transactions in the functional currency when several exchange rates are available. Hence, despite the issue's widespread applicability, the Interpretations Committee decided not to take the first issue onto its agenda.

With respect to the second issue, the Interpretations Committee observed that a longer-term lack of exchangeability is not addressed by the guidance in IAS 21, and so it is not entirely clear how IAS 21 applies in such situations. However, the Interpretations Committee thought that addressing this issue is a broader-scope project than it could address. Accordingly, the Interpretations Committee decided not to take this issue onto its agenda.

⁸ Reproduced from [November 2014](#) IFRIC Update.

However, the Interpretations Committee noted that several existing disclosure requirements in IFRS would apply when the impact of foreign exchange controls is material to understanding the entity’s financial performance and position. Relevant disclosure requirements in IFRS include:

- (a) disclosure of significant accounting policies and significant judgements in applying those policies (paragraphs 117–124 of IAS 1 *Presentation of Financial Statements*);
- (b) disclosure of sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, which may include a sensitivity analysis (paragraphs 125–133 of IAS 1); and
- (c) disclosure about the nature and extent of significant restrictions on an entity’s ability to access or use assets and to settle the liabilities of the group, or its joint ventures or associates (paragraphs 10, 13, 20 and 22 of IFRS 12 *Disclosure of Interests in Other Entities*).

Appendix B—Agenda decision published in September 2018⁹***Determination of the exchange rate when there is a long-term lack of exchangeability (IAS 21 The Effects of Changes in Foreign Exchange Rates)***

The Committee considered the determination of the exchange rate an entity uses to translate the results and financial position of a foreign operation into its presentation currency applying IAS 21. The Committee considered this matter in the following circumstances:

(a) the exchangeability of the foreign operation's functional currency with other currencies is administered by jurisdictional authorities. This exchange mechanism incorporates the use of an exchange rate(s) set by the authorities (official exchange rate(s)).

(b) the foreign operation's functional currency is subject to a long-term lack of exchangeability with other currencies—ie the exchangeability is not temporarily lacking as described in paragraph 26 of IAS 21; it has not been restored after the end of the reporting period.

(c) the lack of exchangeability with other currencies has resulted in the foreign operation being unable to access foreign currency using the exchange mechanism described in (a) above.

The Committee observed that those circumstances currently exist in Venezuela.

The Committee discussed whether, in those circumstances, an entity is required to use an official exchange rate(s) in applying IAS 21.

The Committee observed that an entity translates the results and financial position of a foreign operation into its presentation currency applying the requirements in paragraphs 39 and 42 of IAS 21. Those paragraphs require an entity to translate:

(a) the assets and liabilities of the foreign operation at the closing rate; and

⁹ Reproduced from [September 2018](#) IFRIC Update.

(b) income and expenses of the foreign operation at the exchange rates at the dates of the transactions if the functional currency of the foreign operation is not the currency of a hyperinflationary economy, or otherwise at the closing rate.

The closing rate and the rates at the dates of the transactions

Paragraph 8 of IAS 21 defines (a) the ‘closing rate’ as the spot exchange rate at the end of the reporting period; and (b) the ‘spot exchange rate’ as the exchange rate for immediate delivery. In the light of those definitions, the Committee concluded that the closing rate is the rate to which an entity would have access at the end of the reporting period through a legal exchange mechanism.

Accordingly, the Committee observed that in the circumstances described above an entity assesses whether the official exchange rate(s) meets the definition of the closing rate—ie is it the rate to which the entity would have access at the end of the reporting period? Similarly, if the foreign operation’s functional currency is not the currency of a hyperinflationary economy, the entity also assesses whether the official exchange rate(s) represents the exchange rates at the dates of the transactions in applying paragraph 39(b) of IAS 21.

Continuous assessment of facts and circumstances

In the circumstances described above, economic conditions are in general constantly evolving. Therefore, the Committee highlighted the importance of reassessing at each reporting date whether the official exchange rate(s) meets the definition of the closing rate and, if applicable, the exchange rates at the dates of the transactions.

Disclosure requirements

An entity is required to provide information that is relevant to an understanding of an entity’s financial statements (paragraph 112 of IAS 1 *Presentation of Financial Statements*). The Committee highlighted the importance of disclosing relevant information in the circumstances described above. In particular, the Committee observed that the following disclosure requirements may be relevant to an understanding of an entity’s financial statements:

(a) significant accounting policies, and judgements made in applying those policies that have the most significant effect on the amounts recognised in the financial statements

(paragraphs 117–124 of IAS 1);

(b) sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year, which may include sensitivity analysis (paragraphs 125–133 of IAS 1); and

(c) the nature and extent of significant restrictions on an entity's ability to access or use assets and settle liabilities of the group, or in relation to its joint ventures or associates

(paragraphs 10, 13, 20 and 22 of IFRS 12 *Disclosures of Interests in Other Entities*).

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to assess whether, in the circumstances described above, it uses the official exchange rate(s) to translate into its presentation currency the results and financial position of a foreign operation. Consequently, the Committee decided not to add this matter to its standard-setting agenda.

Appendix C—Stakeholder comments on Committee’s decision to research possible narrow-scope standard setting¹⁰

46. The ANC, the ASBJ, Deloitte and KPMG commented on the Committee’s decision to research possible narrow-scope standard setting to address the exchange rate an entity uses when the spot exchange rate is not observable.
47. The ASBJ suggests that the Board (i) amend IAS 21 to set out requirements specifying the exchange rate an entity uses when there is a long-term lack of exchangeability; (ii) define what a longer-term lack of exchangeability is; and (iii) require specific disclosures.
48. KPMG suggests that the Committee develop an Interpretation to clarify (i) which exchange rate an entity uses when there is a long-term lack of exchangeability, (ii) the circumstances in which there is a long term lack of exchangeability, and (iii) how an entity determines an estimated exchange rate.
49. Deloitte recommends that any standard-setting address currency restrictions in a holistic manner, including the circumstances in which the exchangeability of a currency is restricted (but still occurring) and those in which a currency is not exchangeable at all.
50. The ANC questions whether the research should be limited to the requirements in IAS 21 or should also consider how the matter affects other IFRS Standards.

¹⁰ Reproduced from paragraphs 46–50 of [Agenda Paper 10](#) for the Committee’s September 2018 meeting.